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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of:	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Transport Rate Structure and Pricing	CC Docket No. 91-213

REPLY COMMENTS OF GTE

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on behalf of its affiliated
domestic telephone and interexchange
companies

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SUMMARY

Access reform must pave the way for efficient competition by promoting rational pricing and discarding outdated and overly intrusive regulation. On a going-forward basis, prices for access (as well as unbundled network elements) must be set through competitive principles that are based on market risks and rewards rather than government intervention and give-aways. Likewise, the FCC* should not kowtow to IXC efforts to skew competition in their favor by arbitrarily driving down access prices without due consideration for marketplace principles.

At the same time, the Commission must recognize that the advent of local competition has fundamentally breached the longstanding regulatory compact under which franchised ILECs were provided the opportunity to recover their embedded and current, actual costs in exchange for providing certain services at uneconomically low rates. The President's Council of Economic Advisers recognized this when it recently recommended that ILECs be given a fair opportunity to recoup unrecovered investment expenses. For reform to proceed in a lawful manner, the Commission must face up to the issues it ducked in the *Interconnection* and *Universal Service* proceedings by giving ILECs a fair opportunity to recover costs.

GTE's Reform Plan. GTE's reform plan properly balances these rational pricing and cost recovery objectives. The hallmark of this plan is immediate institution of pricing flexibility reforms, including geographic deaveraging, volume and term discounts, customer-specific pricing and rapid introduction of new services, and recovery of regulatory policy costs through a competitively neutral mechanism. Such action will enable ILECs to price efficiently and lay the groundwork for fully competitive local service and access markets. Together with this flexibility, the Commission should simplify the price cap system by

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* Abbreviations used in this summary are the same as used in the body of the reply comments.

establishing only one Network Services basket, with three service categories and zone pricing for those services not yet subject to effective competition. The FCC should forbear from regulating services that are fully subject to competitive pricing pressures, including special access, switched access dedicated transport, interstate intraLATA, operator surcharges, and directory assistance services.

Immediate reforms to the access charge system should also be implemented to produce rational service pricing. First, the SLC cap should be eliminated, and the SLC should be geographically deaveraged. If the FCC finds that this would make service unaffordable, any unrecovered costs should be funded through the new universal service mechanism. Second, costs now recovered through the TIC should be reassigned to other access elements that cause such costs, and any costs that cannot be rationally reassigned should be recovered through the regulatory policy cost recovery mechanism noted below. Third, the FCC should permit ILECs to establish a competitively neutral charge to recover (a) costs under-recovered in past periods because of FCC-prescribed depreciation rates, (b) misallocations of costs to the interstate jurisdiction (including the remaining unreallocated portion of the TIC), (c) any carrier common line (loop) costs not recovered through subscriber line charges or the universal service mechanism, and (d) the difference between existing local switching rates (after removal of implicit subsidies) and any Commission-prescribed rates, e.g., rates based on hypothetical forward-looking costs.

Cost Recovery. A critical element of this plan is that ILECs must be allowed to recover legitimate costs. Chairman Hundt asked five basic questions about cost recovery in a recent speech. The answers to those questions are as follows:

- ILECs should be permitted the opportunity to recover two different categories of costs: (1) historical costs that include under-recovered depreciation and (2) current, actual interstate-allocated costs of operating the network. The amount of costs to be recovered should be demonstrated through a cost showing at the time the recovery mechanism is first instituted.

- A regulatory cost recovery mechanism should be established immediately.

- The Commission should not and cannot lawfully consider revenues from other lines of business in determining recovery of these costs.

- The FCC has jurisdiction to determine recovery of costs assigned to the interstate jurisdiction and need not defer its action until states create mechanisms for recovering costs assigned to the intrastate jurisdiction.

- Regulatory policy costs should be recovered through a flat rate charged to all carriers that use ILEC facilities to provide interstate services.

GTE has previously unrecovered interstate investment of $1.6 billion. The FCC should reject claims by IXCs that such costs are imprudent or excessive. Regulators have either thoroughly reviewed and approved these investments or they were placed in service under incentive regulation, like federal price caps, that assures that they are prudently incurred. The FCC should also reject IXC claims that ILECs had a fair opportunity to recover these costs in past earnings. The FCC cannot fabricate a retroactive write-off by declaring that past profits "recover" costs that were deferred under then-existing depreciation and cost accounting rules. Further, ILECs will not likely be able to recover these costs in the future because (1) inter-service support flows at the federal level are prohibited by Section 254(e) and (2) the availability of unbundled elements and competitive offerings will preclude such recovery from access charges, and (3) earnings from other services will not be sufficient in any event. Finally, the FCC should reject IXC arguments for TSLRIC or TELRIC pricing of access services. The FCC should abandon the use of TSLRIC or TELRIC for use in pricing access, unbundled elements, universal service, or any other product because they do not permit recovery of legitimate, ongoing costs of the network. If the FCC does not permit recovery of embedded or actual, current costs of operating the network, it will work an unconstitutional taking.

Rational and Efficient Pricing. GTE's plan will produce rational and efficient pricing. Proposals to eliminate SLC caps and recover common line costs directly from end users received substantial record support. If the FCC finds this makes rates unaffordable, any costs which would not be recovered through

SLCs should be recovered through the universal service mechanism or, failing that, through GTE's regulatory policy cost recovery mechanism. The FCC should reject arguments that SLCs should be decreased, because this would exacerbate the current uneconomic way in which common line costs are recovered.

Many parties agreed with GTE that the TIC should be reformed by reassigning legitimately interstate costs to more appropriate rate elements. Remaining costs, which are derived from separations misallocations, also should be recovered through the regulatory policy cost recovery mechanism.

The FCC should reject IXC attempts to nearly double the current productivity factor. The FCC should follow its price cap precedent by establishing an X factor based on historical ILEC productivity levels and not create a factor that will arbitrarily force prices lower. Many parties supported restructuring the current, complicated basket and bands structure. Such reform will simplify price cap regulation and make pricing more responsive to consumer needs. The FCC should resist adopting other proposals which do not fully permit efficient pricing and which do not give ILECs an adequate opportunity to recover costs, such as proposals that would eliminate a cost recovery mechanism when a competitor serves an end user using the ILEC network.

Immediate Pricing Deregulation. The FCC should grant ILECs immediate pricing flexibility without making burdensome and unnecessary competitive showings. Claims that unbundled element pricing will not check access pricing must be rejected. The record demonstrates that interconnection agreements are in place, enabling competitors to easily compete with access offerings at the time access reforms become effective. Complaints by IXCs that GTE is challenging arbitration decisions in court are irrelevant to this argument: GTE is entitled under the statute to appeal noncompensatory and unlawful interconnection rates, just as other parties are.

The Commission should resist ILEC competitors' requests that it establish detailed and burdensome competitive showings before granting pricing flexibility and other reforms. Market share triggers are not only burdensome, they are unnecessary to show that access prices are constrained by market forces. The existence of large, sophisticated access customers, who can obtain price concessions or bypass ILEC access services obviate the need for such showings. Immediate pricing flexibility is necessary to prevent competitive distortions and benefit consumers through a wider range of service offerings, enhanced network efficiency and lowered network costs.

The Commission should reject IXC claims that government-prescribed rates are necessary to produce competition. A prescriptive approach would substantially undermine the competition and quick deregulation Congress intended to produce. The prescriptive approach suggested by the IXCs and the FCC would also be needlessly burdensome during the brief period before full competition exists and would also skew competition.

Therefore, GTE urges the Commission to reject IXC and CLEC arguments for inflexible and below-cost pricing. Adopting GTE's plan would strike the proper balance between competition and cost recovery for the benefit of consumers and competition.

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REPLY COMMENTS OF GTE

GTE Service Corporation ("GTE"), on behalf of its affiliated domestic local exchange and interexchange telephone companies, submits these reply comments in response to comments filed regarding the Commission's access charge reform proposals.[1] The record makes clear that the FCC must pave the way for efficient competition by promoting rational pricing of access services and discarding outdated and overly intrusive regulation. On a going forward basis, prices for access (as well as for unbundled network elements, which are functionally equivalent) must be set by the market – not by some hypothetical and entirely unrealistic cost model or prescriptive approach that would deny just compensation and perpetuate regulatory micromanagement. Congress intended that all industry players be allowed to fully and vigorously compete in all telecommunications markets. Granting incumbent local exchange carriers ("ILECs") immediate, substantial pricing flexibility – coupled with recovering regulatory policy costs through a competitively neutral mechanism – is the only way to ensure rational pricing and promote competition based on market risks and rewards rather than government-sponsored give-aways.

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[1] Access Charge Reform, CC Docket No. 96-262, FCC 96-488 (rel. Dec. 24, 1996) ("*NPRM*"). Parties' comments in this proceeding are cited in the format "party page number" (e.g., "GTE 2").

At the same time, the Commission must recognize that the advent of local competition has fundamentally breached the longstanding regulatory compact under which franchised ILECs were provided the opportunity to recover their embedded and current, actual costs in exchange for providing certain services at uneconomically low rates. For reform to proceed in a lawful manner, the Commission must face up to the issues ducked in the *Interconnection* and *Universal Service* proceedings by giving ILECs an opportunity to recover costs engendered by past policies that have become untenable in the new regulatory environment. To this end, ILECs should be permitted an embedded cost recovery mechanism that is transitional and competitively neutral. For ongoing regulatory policy costs, such as separations misallocations, similar mechanisms should be maintained unless and until the rules are changed to eliminate these costs. As detailed herein, GTE's reform plan advances these rational pricing and cost recovery objectives in a manner that will benefit consumers by fostering true marketplace competition.

I. INTRODUCTION

A. GTE's Access Reform Proposal Will Produce Efficient Pricing, Allow Appropriate Cost Recovery, and Promote Competition.

GTE has proposed a relatively simple plan for access reform that will benefit consumers, promote efficient competition, and ensure adequate cost recovery. The hallmark of this plan is immediate institution of pricing flexibility reforms, including geographic deaveraging, volume and term discounts, customer-specific pricing and rapid introduction of new services. Such action will enable ILECs to price efficiently and lay the groundwork for fully competitive local service and access markets. Together with this flexibility, the Commission should simplify the price cap system by establishing only one Network Services basket, with three service categories and zone pricing for those services not yet subject to effective competition. The FCC should forbear from regulating services that are fully subject to competitive pricing pressures, including special access, switched access dedicated transport, interstate intraLATA, operator surcharges, and directory assistance services.

Immediate reforms to the access charge system should also be implemented to produce rational pricing of services. As the comments underscore, existing irrational pricing approaches need to be removed or reformed promptly. First, the subscriber line charge ("SLC") cap should be eliminated and SLCs should be geographically deaveraged. If the FCC finds that this makes service unaffordable, any unrecovered costs should be funded through the new universal service mechanism. Second, costs now recovered through the transport interconnection charge ("TIC") should be reassigned to the access elements that cause such costs, and any costs that cannot be rationally reassigned should be recovered through the regulatory policy cost recovery mechanism noted below. Third, the FCC should permit ILECs to establish a competitively neutral charge to recover (a) costs under-recovered in past periods because of FCC-prescribed depreciation rates, (b) misallocations of costs to the interstate jurisdiction (including the remaining unreallocated portion of the TIC), (c) any carrier common line (loop) costs not recovered through subscriber line charges or the universal service mechanism, and (d) the difference between existing local switching rates (after removal of implicit subsidies) and any Commission-prescribed rates, e.g., rates based on hypothetical forward-looking costs. These reforms are essential without regard to the state of competition.

B. The Comments Underscore the Importance Of Giving ILECs the Opportunity to Recover Embedded Costs.

The President's Council of Economic Advisors agreed with GTE's position on the recovery of embedded costs in its recent report to Congress:

> One question in addressing universal service and access charges is whether, after deregulation, the earnings of incumbent telephone companies will suffice to cover the infrastructure costs mandated under prior regulatory regimes . . . . [R]ecovery of costs legitimately incurred pursuant to regulatory obligations would be warranted. Such recovery should be limited, however, to investment expenses not already recovered through past earnings. It is also crucial that any such recovery be accomplished in a manner that is competitively neutral . . . .[2]

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[2] Annual Report of the Council of Economic Advisers at 204-05 (Feb. 1997).

The following analysis details how the conclusion of the Council of Economic Advisers should be implemented and how the interexchange carriers' ("IXCs") positions on this issue should be rejected.

The record overwhelmingly supports both the appropriateness and the legal necessity of permitting ILECs to recover not only their historic costs incurred in meeting carrier-of-last-resort obligations, but also their actual, current costs on a going forward basis. As to historical costs, ILECs have spent decades investing in networks and expanding service to virtually all Americans to create the best telecommunications system in the world. This system will be even further improved with robust competition in all telecommunications sectors. But true competition will not materialize through short-sighted policies that fail to compensate ILECs fairly for their in-place networks, which are the backbone networks that ILECs, many access customers and some competitive local exchange carriers ("CLECs") will rely on for at least the immediate future.

Some IXCs now claim that ILEC "embedded costs" are excessive because they include "strategic investment" and waste. Oddly, these same parties even argue that ILECs might be better off using Total Service Long Run Incremental Cost ("TSLRIC") for some types of assets because replacement costs exceed book values. These claims are nonsense. As more fully detailed below, ILEC costs have been either thoroughly reviewed by regulators and determined to be prudently incurred or have been incurred under incentive regulation, like federal price caps, that promotes efficient investment. In truth, the IXCs want ILECs to write off legitimate past costs in order to fatten their own price-cost margins.

As to current costs, GTE seeks a suitable balance between cost recovery and deregulation. The IXCs, however, are attempting to redefine costs to make them magically disappear. In such respects, the record documents that TSLRIC will not give ILECs a fair opportunity to recover even their forward-looking costs. TSLRIC and Total Element Long Run Incremental Cost ("TELRIC") should be abandoned as a

means of establishing prices. These methodologies should only be used where economists agree that they are appropriate; namely, to determine cross-subsidization in a multi-product firm. Such pricing rules, like other government efforts to "create" competitive prices, are doomed to failure. The FCC's adoption of below-cost unbundled element pricing in the interconnection docket is an example of such a failure, which, in turn, exacerbates the problem of reasonable access pricing. Only if regulatory policy costs are recovered in a competitively neutral manner and prices for access and other telecommunications services are set in accordance with marketplace principles can the Congress' and the FCC's goal of competition be achieved.

C. GTE's Proposal for Rate Structure Reforms Would Produce a Balanced Result Consistent with Rational Service Pricing.

The record reflects virtually unanimous agreement that access pricing must be made more rational. Rational pricing requires that costs be recovered in the manner in which they are incurred and that rates fairly recover costs and reflect market conditions. GTE's proposal rises to this challenge. It achieves a reasoned balance among customers, competitors, and ILECs by:

- recovering the non-traffic sensitive costs of interstate-allocated loop costs through flat pricing,
- creating a competitively neutral mechanism for recovery of costs that were created by regulatory policy choices,
- achieving pricing efficiencies through geographically deaveraged rates and volume and term discounts,
- promoting competition and quality customer service through customer-specific pricing and speedy introduction of new services, and
- increasing pricing efficiency and reducing cross-subsidy opportunities through a simplified price cap basket structure and deregulation of competitive services.

Although IXCs and others understandably would rather shackle the ILECs so that they can gain a competitive advantage, the FCC should not kowtow to their thinly veiled tactics. Their comments fail to

unearth valid reasons for prescribing new rates, undermining price cap efficiencies, or continuing to prevent ILECs from responding to competition. To benefit consumers, all players must be allowed to compete on equal terms, and the market must be permitted to create efficient pricing.

D. Marketplace Competition Would Be Impeded By IXC Proposals To Block Or Delay Access Charge Pricing Flexibility And Deregulation.

The FCC is by now accustomed to IXCs' gaming the regulatory process in efforts to restrain competition.[3] It should be highly skeptical of requests for delayed regulatory reforms and barriers to marketplace competition. Genuine competition cannot be achieved in an asymmetrical regulatory environment.

In this proceeding, competitors claim that ILECs must lose substantial market share before any deregulation can go forward. PUCO 10; WorldCom 86-89. Some even argue that local exchange and exchange access may never be competitive. WorldCom 5,15. In contrast, Congress passed the 1996 Act with the clear intention that these markets become competitive and be quickly deregulated.[4] Imprisoning important competitors like the ILECs in a Byzantine maze of stultifying regulations will not benefit consumers, even in the short run. The Commission must take the high road by helping to create a market environment that will achieve Congressional and FCC goals now, without further delay or additional protracted proceedings. Reforming access charges in a manner that does not rapidly advance this goal is tantamount to snatching defeat from the jaws of victory

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[3] MCI spent the better part of the 1980s and early 1990s trying to keep AT&T from gaining the flexibility to reduce its rates.

[4] The intent of the 1996 Act is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapid private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition." Joint Statement of Managers, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess., Preamble (1996).

II. ILECS MUST BE PERMITTED TO RECOVER THEIR ACTUAL AND EMBEDDED COSTS RATHER THAN BEING LIMITED TO HYPOTHETICAL COSTS GENERATED BY THEORETICAL MODELS.

A. GTE's Answers To Recovery of Embedded Cost Questions Posed by Chairman Hundt.

GTE is heartened that the issue of embedded cost recovery is still an open one. In a January 14, 1997 speech, Chairman Hundt asked several questions about embedded cost recovery. Set forth below are specific responses to each of the Chairman's questions. GTE's answers clearly show how the cost recovery problem can be solved to everyone's benefit.

1. How can the amount of embedded costs be determined?

It is important to note that the issue of cost recovery should include two separate categories of costs. First, "embedded costs" include under-recovered depreciation – that is, investment that is recorded on ILEC's regulated books of account but has not yet been recovered in rates. Second, cost recovery should also include current, actual costs of operating the network that (1) are recorded in regulated books of account on a recurring basis pursuant to FCC rules and (2) regulators have allowed ILECs to recover to date, but (3) may not be recoverable in the future if certain proposals are adopted. The costs recovered in the carrier common line ("CCL") and TIC are two examples of such current, actual costs.[5] If the CCL and TIC are simply eliminated, as some parties have argued, actual ILEC costs will not be recovered.[6]

ILECs must be given the opportunity to recover both categories of costs. The method of recovery depends on the type of cost involved.[7] The amount of these costs should be determined through an ILEC

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[5] GTE uses the term actual costs to mean current, not historical, costs.

[6] Another clear example would be pricing at TSLRIC as formulated by the FCC in the *First Interconnection Order*, which GTE has demonstrated does not recover its actual costs. GTE 21.

[7] For instance, if some of the truly interstate TIC costs are recovered in more appropriate rate elements, no further recovery method for these costs is necessary. Any residual costs, such as the costs misallocated to the TIC through the separations and Part 69 rules, are more appropriately recovered through a separate charge imposed on all telecommunications carriers that purchase interstate switched

cost showing made at the time the recovery mechanism is first established, updated periodically as the type of costs allocated to the interstate jurisdiction are changed. GTE estimates that the cost recovery issue entails about $1.6 billion due to depreciation (*i.e.*, embedded costs), $84.6 million in marketing expenses allocated to the interstate jurisdiction through the separations process, $699 million to the CCL, and $182 million to the TIC.[8]

2. When will the determination be proper?

The recovery mechanism should be established immediately. The parties in this docket are unanimous that access reform is long overdue. Growing competition exacerbates the anticompetitive consequences flowing from these outdated rules. Because GTE's cost recovery mechanism is specifically designed to be competitively neutral, there is no need for a phase-in period.

3. What revenues are counted to cover costs?

Only access revenues are relevant to determining how interstate-allocated embedded costs of access are recovered. Revenues from other lines of business are irrelevant to the issue of embedded cost recovery for access services.[9] In fact, the notion that other revenues, like interexchange service revenues, might be used to offset the costs of providing other services is a throwback to the 1940s, when policymakers were looking for some way to keep local service rates low.[10] This implicit subsidy program is precisely why it is now so difficult to deregulate communications markets: the elaborate system of hidden subsidies cannot be sustained in a competitive market.[11]

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access, transport, and facilities used to provide interstate services from ILECs.

[8] These figures are based upon 1995 data. *See* GTE Apps. B & C.

[9] GTE has already explained how mandating that other lines of business subsidize access is inconsistent with the Communications Act, unconstitutional, and economically unsound policy. GTE 81-82.

[10] Schmalensee & Taylor, attached to USTA's Comments, delineate how long distance rates were forced to remain relatively high so that local service rates would not rise.

[11] In fact, the suggestion that long distance revenues be used to subsidize local or access rates is quite ironic given the fact that the FCC is looking for ways to avoid cross-subsidy in its proposal to prevent facilities sharing between an ILEC and its long distance affiliates. Implementation of the Non-Accounting

Recognizing this fact, Section 254(e) of the Communications Act mandates that at the federal level, the FCC make support explicit, not hidden. The Commission must be aware that it is currently considering whether to adopt the Joint Board's *Recommended Decision* on how to eliminate historic implicit subsidies, including subsidies in the access charge system itself. It would be both thoughtless public policy and unlawful for the FCC to mandate a new implicit subsidy in place of the ones it is about to eliminate.[12]

What is more, it is naïve to believe that revenues from new businesses will be large enough to recover both their own costs and the massive embedded costs of the local telephone business. Further, increased revenues due to demand stimulation from a cut in access prices, even if they arise, could not recover embedded costs. With incremental cost pricing, any increased demand would also entail increased costs, which would eliminate any margin that could cover embedded costs. The goals of competition and cost recovery can best be realized by adopting a competitively neutral mechanism for recovering regulatory policy costs and allowing full freedom for ILECs to compete.

4. Who has jurisdiction?

It is clear that the FCC has jurisdiction to decide the issue of recovering interstate-allocated embedded costs. States have jurisdiction over the intrastate portion. These issues can and should be decided as separate issues by the regulators with the appropriate jurisdiction. Although the overall issue of company-wide embedded costs has both federal and state aspects, joint evaluation and decisionmaking is not essential. However, to the extent that the FCC believes that certain costs allocated to the interstate

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Safeguards of Sections 271 and 272 of the Communications Act of 1934 and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Areas, CC Docket No. 96-149, FCC 96-308 (rel. July 18, 1996).

[12] Of course, when an ILEC provides interexchange services it is required to charge itself a nondiscriminatory price for access. An ILEC's interexchange service business will, therefore, pay for a fair share of the recovery of embedded and actual costs just like other users of ILEC networks should. This is a far cry, however, from ignoring cost recovery because interexchange revenues might be used to defray

jurisdiction should be reallocated to the intrastate jurisdiction, it must do so through a Federal-State Joint Board process until such a reallocation decision is made, the FCC must meet its obligations under federal statute to allow full cost recovery of interstate-allocated costs.[13]

5. Who should pay the costs?

The most critical aspect of GTE's plan for recovery of embedded costs is that the mechanism be competitively neutral. GTE proposes to recover its regulatory policy costs through a flat rate charged to all interstate transport and switched access customers and other purchasers of ILEC facilities used to provide interstate services, including the ILEC when it provides its own interstate interexchange services. The carriers that use GTE's network to provide service are the ones that should pay these costs because they are the ones that benefit most directly from these facilities.

GTE is adamantly opposed to the notion that a regulatory policy charge not be imposed where a non-facilities based CLEC continues to use GTE's network through resale or unbundled network elements. Entities that continue to use and benefit from GTE's network should continue to pay the full costs. Eliminating the charge in these circumstances forces GTE to recover these costs over its remaining access customers. The higher the charges to the remaining customers become, the faster these access customers will be driven to CLECs. The ensuing "death spiral" of increased charges and lost customers will eventually devastate the ILEC, harming its own customers, those of non facilities-based CLECs, and ILEC shareholders. This would be disastrous public policy. In contrast, a competitively neutral charge, as espoused by the Council of Economic Advisors, assessed against all users of ILEC networks for interstate purposes will permit continued maintenance of those networks and be procompetitive.

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these costs.

[13] Contrary to suggestions by some parties, separate decisionmaking will not increase the risk of double recovery. The FCC and state regulators can avoid this possibility by relying on sources, such as ARMIS reports, that clearly set out interstate and intrastate costs. Federal or state auditing can also prevent such a result.

B. The IXCs' Criticisms of Embedded Cost Recovery Are Unwarranted and Blatant Attempts to Harm Competitors.

The IXCs, in a transparent effort to force ILECs to underwrite their businesses, raise numerous baseless arguments in opposition to permitting recovery of embedded costs in the new competitive environment. For example, they claim that embedded costs reflect imprudent or excessive investments; ILECs have had or will have ample opportunity to recover any legitimate embedded costs; setting access charges based on TSLRIC will send appropriate economic signals and assure adequate cost recovery; and ILECs have no entitlement to recover asset values that have been impaired by the introduction of competition. AT&T 31-37; IXC Long Distance 5-6; MCI 28-32, 71-75; Sprint 55; Telco 7-8. As discussed below, these arguments have no legal or factual merit.

1. Claims that ILEC embedded costs are imprudent or excessive should be rejected.

Some IXCs claim that ILEC estimates of embedded costs are overstated. AT&T 31; MCI 72-75. In particular, a study by Kravtin and Selwyn attached to AT&T's pleading argues that much of embedded investment was incurred after 1990. Because of this assertion, the study concludes that ILECs are not entitled to recover these costs because (1) price cap regulation was meant to put this investment at risk, (2) much of this investment is intended for use in providing competitive services (such as additional lines or vertical services), and (3) much of this investment is spare capacity. They also argue that, because forward-looking costs exceed embedded costs for some types of plant, a forward-looking methodology will place the ILECs in a better position than they could achieve through an embedded cost recovery mechanism. AT&T, Kravtin & Selwyn iii-iv.

The attached affidavit of Timothy J. Tardiff,[14] as well as the affidavit of Strategic Policy Research,[15] analyze these allegations and conclude that the study is useless as support for AT&T's and other IXC

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[14] Affidavit of Timothy J. Tardiff (App. A) ("Tardiff Affidavit").

assertions. The claims made by Kravtin and Selwyn are false and internally inconsistent in several major respects.[16]

First, the risk of nonrecovery of investment under price cap regulation cannot fall on the ILEC if the pricing flexibility contained in the price cap plan is nullified. By represcribing rates, the opportunity to recover those costs is destroyed. What is more, the FCC continued under price caps to constrain ILEC depreciation practices,[17] over the protests of GTE and others.[18] The FCC's depreciation practices carry with them the implicit assumption that ILECs eventually would be permitted to recover these amounts. In a monopoly environment, such an assumption is realistic. Now that competition will replace this environment, however, the FCC cannot agree with IXCs that want to "wish away" the problem through revisionist history that ILECs assumed the risks of depreciation cost recovery while price cap regulations were in effect. The "risk" GTE assumed was that of normal business fluctuations, not of government confiscation.[19]

Second, the investment recorded on regulated books is only for regulated services pursuant to the FCC's Part 64 rules. Local loops are installed for the purpose of providing regulated local services. In state tariffs, there is no distinction between primary and additional lines. Therefore, these costs are legitimate embedded investment; a portion of all these lines is allocated to the interstate jurisdiction pursuant to government mandated separations procedures. Valid regulated costs cannot be ignored

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15 Strategic Policy Research, The Depreciation Shortfall, attached to USTA's Reply Comments in this proceeding ("Strategic Policy Research").

16 Kravtin and Selwyn's claim that 65% of all investment was made after 1990 is overstated although GTE believes that a significantly lesser percentage of its investment was made since 1990, but the two-week reply period was insufficient for GTE to perform full analysis of this data. In any event, this claim is immaterial because the timing of investment is irrelevant to whether these costs should be recovered.

17 *See* Simplification of the Depreciation Prescription Process, 8 FCC Rcd 8025 (1993).

18 Comments of GTE Corp. in AAD 96-79 (Aug. 28, 1996).

19 The Strategic Policy Research likens this AT&T analysis to third world economics where a developing country encourages investment with a promise of eventual profits, only to later nationalize the assets once profitable as a "consumer dividend."

simply because someone arbitrarily claims they relate to services that are now competitive. Moreover, much of the investment in digital switches, which Kravtin and Selwyn claim to be for the provision of competitive vertical service, were, in fact installed at the direction of state commissions to better serve basic telephone subscribers.[20] In addition, digital switches were installed to meet equal access needs pursuant to IXC requests.[21] Kravtin and Selwyn's rewrite of the historical reason for modernizing plant should thus be discarded.

Third, prudent business practice demands that ILECs invest in capacity to accommodate future growth (including traffic growth from access customers and purchasers of unbundled elements). Spare capacity economically and prudently placed does not constitute "excess" investment. What is more, loop and switching plant are most economically installed in reasonably sized increments. Only installing enough capacity to meet current demand would result in increased total costs over typical ILEC practices. Moreover, the amount Kravtin and Selwyn claim to be associated with excess investment in spare capacity is meaningless because they assume that plant in growth and no-growth areas can be readily redeployed. The absurdity of their results is apparent in the fact that they find that 1996 investment should be 30 percent lower than in 1990, even though ILEC traffic has grown by over 20 percent during that same time period.[22]

Finally, the claim that forward-looking costs are equal to embedded costs, or exceed them in the case of outside plant investment in cable, buildings, conduit and poles, is flatly contradicted by the AT&T-

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[20] *See, e.g.,* Amendments to the Special Rules Telecommunications, Docket No. 95-255-R at 3 (Ark. Pub. Serv. Com. June 20, 1995); Commission Initiated Investigation to Establish Requirements for the Telecommunications Infrastructure in Minnesota, Docket No. P-999/CI-93-1176 (Minn. Pub. Util. Com., issued Feb. 21, 1995) ("Minn. Decision"); Local Exchange Telecommunications companies' modernization plans pursuant to 4 CSR 240-32.100, Case No. TO-93-309, at 11 (Mo. Pub. Serv. Com., Aug. 29, 1994); General Order of the Oklahoma Corporation Commission Amending and Establishing Certain Rules Governing Telephone Service, Order No. 380024, at 4 (Okla. Corp. Com., Feb. 3, 1994).

[21] *See, e.g.,* Minn. Decision at 3.

[22] Tardiff Affidavit at 6.

sponsored Hatfield model. AT&T contradicts itself by loudly asserting at every opportunity that Hatfield estimates investment in these categories at only about one-half of the embedded amount, not larger as the Kravtin and Selwyn study assert.[23] For all of these reasons, IXC claims that embedded costs are overstated should be summarily rejected.

2. ILECs have not had and will not have a fair opportunity to recover embedded costs without specific FCC action.

In the *NPRM*, the FCC acknowledges that ILECs are currently experiencing a shortfall in recovery of their investments, including agency-prescribed underdepreciation of assets. *NPRM*, ¶¶ 249-51. As explained above, there is no basis for assuming that these embedded costs were imprudently incurred or should otherwise be deemed unrecoverable. Rather, the regulatory safeguards and incentives under both rate of return and price cap regimes have insured that such costs were properly expended to meet existing regulatory obligations.

Similarly, there is no basis for concluding that ILECs had the ability fully to recover their embedded costs in the past, but failed to do so. First, ILECs were bound by Commission-prescribed depreciation schedules throughout the relevant period. As BellSouth pointed out, the FCC repeatedly rejected requests to reform its depreciation policies to accommodate the realistic economic life spans of telephone company equipment. BellSouth 58. Recently, the Commission rejected GTE's request to use more realistic depreciation rates in lieu of rates developed by the Common Carrier Bureau based on the Commission's outdated and inadequate depreciation policies.[24] U S WEST documents the fact that, because of the substantial disparities in the prescribed and economic depreciation lives of telephone equipment, a sizable shortfall in recovery has been created. U S WEST 18. Waivers or other special relief to address this

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[23] *Id.* at 5; Strategic Policy Research. AT&T's self-serving manipulation of statistics in this and other dockets clearly destroys any shred of credibility its arguments have on the cost recovery issue. Neither the Hatfield model nor the Kratvin & Selwyn arguments should be accepted.

[24] *See* Prescription of Revised Percentages of Depreciation (MO&O), FCC 96-486, at ¶ 12 (rel. Dec.

deficit were not reasonably available because it was the direct result of the application of agency policy, not an aberrant or unforeseen side effect of the depreciation rules.[25]

Second, ILECs were equally bound by the application of the separations, accounting, and cost allocation rules,[26] and their cost recovery has been closely monitored by the FCC and state agencies. Minnesota Independent Coalition 23-24. Interstate-allocated costs had to be recovered from the federal jurisdiction, i.e., in access charges. The FCC and the public examined access charge rates in annual filings. Moreover, under both rate of return and price cap regulation, ILEC earnings were measured at least for the purpose of triggering refund obligations or sharing mechanisms. Finally, the cost allocation rules prevented recovery of regulated equipment costs from non-regulated services. It follows that, to date, ILECs have not been afforded a realistic opportunity to recover their embedded interstate costs consistent with governing regulatory requirements.

Nor is it likely that ILECs will have an opportunity to recover these embedded costs in the future absent affirmative Commission intervention. The 1996 Act establishes a national policy of promoting the competitive development of virtually all telecommunications markets. Moreover, it expressly disfavors the continuation of (and, necessarily, the creation of new) cross-subsidies to achieve federal universal service support. 47 U.S.C. § 254(e). Thus, the suggestion that ILECs will be able to recover underdepreciation in their future rates for existing or new service offerings does not withstand analysis. *See, e.g.*, NCTA 2, 78; IXC Long Distance 5-6; Time Warner 48.[27]

20, 1996).

[25] *Cf.* NCTA 7-8 (suggesting that ILECs could have sought authority to use remaining life depreciation schedules).

[26] *See* 47 C.F.R. Parts 32, 36, and 64.

[27] Ad Hoc's further suggestion that the deregulation of enhanced services or the cellular wireline set-aside could be construed as compensation for ILEC embedded costs is the worst type of unfounded, post hoc rationalization. Ad Hoc 58-61.

The combination of multiple new entrants in local exchange markets and the arbitrage potential arising from the FCC's and the states' wholesale and unbundled network element pricing policies inevitably will preclude ILECs from recovering these additional costs from their existing customer base.[28] *See, e.g.,* PacTel 44-52. In fact, such recovery will be made even more difficult by the inability of ILECs to reallocate separated costs between jurisdictions.[29] In addition, there is simply no reason to expect that any new service offerings made by ILECs – whether regulated or unregulated – might generate the supranormal returns necessary to recover historical costs as well as the costs of the new offerings. *See, e.g.,* BellSouth 60-61, PacTel 44-52. Further, Tardiff explains that (1) the profit margins from other services are not likely to be sufficient to recover embedded cost, and (2) Kravtin & Selwyn overestimate revenues and erroneously claim that certain existing revenues are "new" and available to subsidize these access costs.[30]

3. TSLRIC and TELRIC are inappropriate for setting either prices for access and interconnection, or costs in the universal service mechanism.

The IXCs seek to compound the detrimental impact of denying embedded cost recovery by urging the Commission to base access charges on TSLRIC or TELRIC. *See, e.g.,* AT&T 20-29, MCI 18-24, Sprint 49-50, CompTel 16-17. They assert that their support for these "forward-looking" methodologies is predicated on the fact that many states are using them to price unbundled elements and interconnection. AT&T 22-29; CPI 21-24. In fact, they claim that access is "functionally equivalent" to unbundled elements and local interconnection and requires consistent pricing, while simultaneously (and inconsistently) denying

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[28] Of course, the risk of nonrecovery is minimized if unbundled network element pricing is based on appropriate costs, which would, in turn, eliminate the uneconomic arbitrage between unbundled elements and compensatory access pricing.

[29] State commenters have indicated serious concerns about the possible impact of this proceeding on jurisdictional separations. Missouri PSC 6; Texas PUC 31-32. *Cf.* Florida PSC 5-7 (separations reform is essential to solving access pricing problems).

[30] Tardiff Affidavit at 7-9.